

# Time for a Second Stimulus

**JOSEPH STIGLITZ**, who was awarded the Nobel Prize for economics in 2001, spoke to the Council on Foreign Relations recently about his new book, *Freefall: America, Free Markets and the Sinking of the World Economy*, and discussed the US recovery, banking regulation and China's stimulus. NPQ editor Nathan Gardels participated in the discussion as a member of the council. Adapted excerpts follow:

**ON THE PROSPECTS OF ECONOMIC RECOVERY IN THE UNITED STATES** | We've pulled back from the precipice, but the current situation cannot be described as a strong recovery. The recession may be over in the way economists describe it—two quarters of negative growth—since growth has turned positive. But the recession is far from over for those who don't have jobs or can't sell the goods they produce.

The official unemployment rate may be 10 percent. But when we factor in those who are no longer looking for work because the recession has gone on so long, the picture looks pretty bad. Since the US Bureau of Labor Statistics collects data on those who have given up looking for work or taken a part-time job, we can calculate that the real unemployment level stands at over 19 percent.

That means one out of five Americans looking for full-time work cannot get it now. And four out of 10 who can't find work have been out of a job for more than half a year, which means whatever savings they had will have dried up while the prospects of re-employment in a good job go way down. That is a serious situation. It is bleaker for those over 50, and bleaker still for black youth, in which one out of two are unemployed.

It is commonly said that growth in jobs always lags behind recovery. The truth is that the recovery hasn't been strong enough to create enough jobs for new entrants to the labor force, no less to bring unemployment from 10 percent back to 5 percent. For that to happen in the US, growth must be at least 3 percent a year. I don't see growth in 2010 or 2011 being above that level.

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## AS THE WORLD TURNS

allowed people to live beyond their means by borrowing. In one year alone in the US, people took \$950 billion out of their houses in equity loans.

During that time, the savings rate in the US plummeted to zero. Clearly, what was unsustainable couldn't be sustained.

The flipside of the burst bubble is that consumption has gone down. For the long turn, that is a good thing. For the short run, that is a problem.

Praying for the consumer to come back in this context is a funny kind of prayer. We shouldn't go back to living beyond our means in the US, which is what created the crisis to begin with. And, certainly for the moment, we can't.

That means a robust recovery is not likely. Without strong consumption, strong investment is not likely.

In the 1997–98 crisis, when Korea, for instance, had this problem, it recovered by exporting what it made to the US and other places that could consume its products. But with Europe down and the US down, we can't all export our way out of this crisis. Trade with Mars is still not big enough.

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Part of the world—Asia—is recovering. But, dynamic as Asia is, its demand is too small overall to make up the shortfall that would lift the US out of recession through exports. That leaves government to fill the gap. The US stimulus has made a difference. If we hadn't had the stimulus, unemployment would be 11 or 12 percent. Yet, it was not big enough or well enough designed to bring employment back to normal levels.

One of the key failures of the stimulus package was that it didn't take into account the fiscal problems the recession would create for state and local governments. When tax revenues go down because of lost economic activity—falling housing prices, closed businesses, lost income from unemployment—budgets have to be cut back. Revenues at the state and local level in the US are down \$200 billion this year. So, while the federal government has been increasing spending, state and local governments have been contracting.

This all will get worse with the end of the stimulus in 2011.

What to do? The US Congress has to pass a second stimulus. It also has to finally really come to grips with the mortgage crisis, which ignited the meltdown. This year we are expecting 2.5 to 3 million foreclosures.

Finally, banks must begin lending again, especially to small and medium-size businesses that create new jobs. This was the rationale for bailing out the banks—but it hasn't worked. There are still no constraints on the banks. They get almost 0 percent credit from the Federal Reserve, and what do they do? They look around the world for investment in the strongest economies—not the US but emerging economies such as Brazil and China. And now that is creating a problem because they are getting speculative money that is creating bubbles there!

Fortunately, these countries have been through this crisis once already and have better banking regulations and monetary policies than the US. Brazil has already introduced restrictions on the inflow of capital, undermining globalization.

**ON BANKING REGULATION** | The regulatory framework of banks is one of the key problems in the US today. Clearly, the current incentive system in banking institutions—for example, the way bonuses are calculated and paid—encourages the very shortsighted risk-taking that brought us to where we are. Size is also a problem.

If banks that are “too large to fail” gamble with risk and win, they walk off with the profits. If they lose, the taxpayer picks up the tab.

I was working in the World Bank at the time of the Asian financial crisis in 1997. The various crises carried the names of countries—Indonesia, Korea, Thailand, etc. But these were not “country” crises. They were banking crises.

The American and European banks lending in East Asia lent to companies beyond

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their ability to pay. What happened? They were bailed out because, if they weren't, it was said, there would be turmoil. So, the International Monetary Fund (IMF) put a gun to their head to make sure the debts were paid. The taxpayers in those countries were forced to bail out the banks. The only difference with this crisis is that the American taxpayers, instead of poor people in Asian countries, are bailing out the banks!

It is a welcome development that there are now discussions in the G-20 and elsewhere about how to change the incentives to get the banks to behave better. Global cooperation in this endeavor would be best because of globalization—banks are good at regulatory and financial arbitrage, sending capital to where they are least regulated.

In Europe, the view is very much that the US is dragging its feet. Europeans are much more adamant about regulation. The head of the Bank of England has said very forcefully, "If you are too big to fail, you are too big to be." Incentives that lead to excessive risk-taking have to be curbed for those institutions that can put at risk an entire economy.

The reality is that the financial system has failed to do its job. Its job is to take savings and transform them into investments with the highest return. Putting savings into housing beyond people's ability to save in the richest country in the world did not do that. Our financial system did not perform its social function.

**ON CHINA** | One of the reasons the Chinese are recovering so well is that they have read all the good American textbooks on macroeconomic management that we've recently ignored. The Keynesian idea, which they've adopted, is that if you have a weak economy, the government should spend. And they are doing it the right way by stimulating the economy in the short run through investments that provide the basis for long-term economic growth.

For example, their stimulus includes spending on a high-speed rail system. Just as the transcontinental railroad changed America's economic geography when it was built, it will do the same for them. Now they have the fastest trains in the world. When completed, that will leave them in a position for faster growth.



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